

THE INVESTMENT COMMITTEE  
OF THE  
MARYLAND STATE RETIREMENT AND PENSION SYSTEM

MINUTES OF OPEN MEETING

September 19, 2017

The Investment Committee convened on Tuesday, September 19, 2017 at 9:15 a.m. in the 16<sup>th</sup> Floor Board Room of the State Retirement Agency, SunTrust Building, 120 E. Baltimore Street, Baltimore, MD.

Committee Members  
Attending:

(1) Via telephone

Michael K. Barry  
David Brinkley  
Eric Brotman  
Peter Franchot  
James Harkins (1)  
Linda A. Herman, Vice-Chair  
Sheila Hill  
F. Patrick Hughes, Chairman

Lisa James-Henson  
Larry E. Jennings, Jr.  
Charles W. Johnson  
Stephen Kitsoulis  
Nancy K. Kopp  
Theresa Lochte  
Richard Norman  
Douglas Prouty

Committee Members  
Not Attending:

David Hamilton

Also Attending:

Victor Adekoya  
Brad Armstrong (GRS)  
James Atwater, Jr. (Marathon Asset  
Mgmt.)  
Frank E. Benham (Meketa)  
Colleen Bower  
Susanne Brogan  
Robert Burd, Deputy CIO  
Elizabeth Burton  
Antionette Butcher  
Juan Chavez (UniteHere!)  
Rachel Cohen, OAG  
Maria Conchas (UniteHere!)  
Melody Countess  
Eric Farls  
David Ferguson  
Laurel Fish (UniteHere!)  
Anne Gawthrop  
Dimitri Grechenko  
Alex Harisiadis, OAG  
Justin Hayes  
Dana Johns  
Faina Kashtelyan  
Gregory Kasten

Larry Katsafanas  
Dean Kenderdine  
John Kenney  
Michael McCord  
Brian Murphy (GRS)  
Mary Mustard (Meketa)  
Stephen Muturi  
Eileen O'Grady (UniteHere!)  
Andrew Palmer, CIO  
Stephen Reilly  
David Rongione, Chief Internal  
Auditor, Internal Auditing Div.  
Michael Rubenstein, (MLIS)  
Dan Schick  
Jody Shaw, OAG  
Frederick "Beau" Smith  
Jared A. Synnestvedt, (Wellington  
Mgmt.)  
Dana Tagalicod, (MLIS)  
Jim Treanor (Pavilion)  
Toni Voglino  
John Wallace (Maryland  
Professional Employees Council)  
Brad Young (Pavilion)

Ms. Herman, Vice-Chairman, called the Investment Committee meeting to order at 9:15 a.m.

**Item 1: UNITE HERE**

UniteHere requested an opportunity to speak to the Investment Committee with respect to the System's investment in the private fund CBRE Global Investors.

Ms. O'Grady, Mr. Chavez, and Ms. Conchas were present. Mr. Chavez and Ms. Conchas are currently employed at Coleman Francisco Bay Hotel. They explained that they would like to consider joining a union without retaliation. They indicated that they had contacted CBRE to express their position, but CBRE had not responded.

Treasurer Kopp thanked them for their presentation and explained that the System is essentially a passive investor in CBRE. As a passive investor, the System does not direct investments or policies for the fund. She stated that the System will notify the manager of what the Committee had heard and try to determine what their practices are relating to this topic.

**Item 2: Minutes**

On a motion made by Mr. Brotman and seconded by Ms. Lochte, the minutes from the July 18, 2017 meeting, previously approved by Mr. Hughes and Ms. Herman, were unanimously ratified.

**Items 3: Meketa Reports**

Meketa Investment Group (Frank Benham and Mary Mustard) presented the Second Quarter of 2017 performance update and current market overview to the Committee.

Mr. Benham discussed the recent performance of the capital markets over the last 6 to 9 months, the reaction to the election of Donald Trump and the policies of the global central banks. Mr. Benham explained that over the last few months the dollar has weakened. He discussed page 5 of the report detailing the index returns of the equity and fixed income asset classes. Ms. Mustard discussed page 16 of the report outlining the System's performance against the benchmark, highlighting that commodities were the worst performing asset class and private equity was the best. Page 19 of the report was discussed which detailed the TUCS results. Ms. Mustard indicated that the System ranked in the 95 percentile of the peer group, which is mostly due to the underweight in public equities in comparison to our peers. She then discussed the activity update on page 53.

Comptroller Franchot expressed concern over the System's TUCS ranking and asked if it was the result of an underweight to public equities. He asked if the ranking would improve when the current market environment changes since the System's allocation is deliberately designed to provide more protection when equities struggle. Ms. Mustard explained that going into the financial crisis, the System was weighted more heavily in equities. This allocation to equities declined during the period following the crises as the market recovered. Ms. Mustard indicated that the System should do better relative to the peer group in periods of equity market declines. Mr. Benham said that the System's portfolio is designed to have less risk. Comptroller Franchot asked how Meketa explains the lack of volatility in the market. Mr. Benham explained that low interest rates and a strong equity market have contributed to the low volatility. Mr. Jennings opined that hedge funds have struggled due to the proliferation of the number of managers over the last decade. Mr. Brotman commented that the System's allocation coming out of the financial crisis attributed to the low peer ranking when stocks outperformed most other asset classes. He stressed the need to maintain the current asset allocation to allow it the opportunity to provide the protection for which it was designed. Ms. Herman asked Meketa to comment on the amount of alpha that was generated in the fiscal year 2017. She also asked Meketa to comment on the System's TUCS ranking, which has not improved since Meketa was hired. Responding to the question on alpha, Ms.

Mustard directed the Committee to page 18 of the report and spoke to the attribution analysis. Mr. Benham commented on Meketa's contributions to the asset allocation process, noting that the changes to the allocation since Meketa's hiring have added value.

Mr. Hughes introduced Stephen Kitsoulis, a new public advisor, and welcomed him to the Investment Committee.

#### **Item 4: Report from CIO**

Mr. Palmer spoke briefly about initiatives: The Investment Division is recruiting for three positions. He indicated that filling positions is difficult due to salary constraints. He also informed the committee that the Investment Division sponsored a pizza lunch fundraiser for hurricane relief on Thursday, September 14, 2017. The amount raised was over \$1000, which will go to help those in need from Hurricane Harvey and Irma.

Mr. Burd discussed page 5 of the CIO Report which outlined performance. He indicated that the System achieved over the 7.55% rate of return over the 1, 5 and 7 year periods, but not over 3 or 10 year. The excess returns over the policy benchmark was positive over every period in the 1, 3, 5, 7 and 10 year performance history. He pointed out that the alpha generated over the past 10 years has added roughly \$2.2 billion over the policy benchmark. On page 6, Mr. Burd indicated that Absolute Return and Public Equity detracted from value, and on page 7, he highlighted how low volatility has been over the past several years. He also discussed page 15 regarding the cash equitization mandate, which is designed to invest cash awaiting allocation to new managers. This is a new program and the product has performed in-line with the System's policy benchmark. Mr. Burd explained that the currency hedging program detracted value by about \$41 million or 9 bps, as the dollar weakened and foreign currencies strengthened in the second half of the fiscal year.

Mr. Katsafanas discussed page 19 and 20 relating to Public Equity; Mr. Ferguson discussed pages 25-19; Mr. Grechenko discussed pages 31-42; and Mr. Reilly discussed page 43. Mr. Hughes asked about our core, opportunity and value added investments in the real estate program, and whether managers have been selling assets. Mr. Reilly confirmed that a significant amount of real estate assets have been sold over the last few years.

Mrs. Burton discussed the Absolute Return Portfolio. She explained that she has met with a large number of managers to continue the restructuring of the portfolio, and her objectives in that restructuring. She highlighted her professional experience and how this experience can be applied to the objectives the System's Absolute Return portfolio. Comptroller Franchot commented that hedge funds are performing poorly. Mrs. Burton explained that while absolute returns have been low, the returns relative to the benchmark require further inspection. The HFRI Fund of Funds Conservative Index is used as a reasonable approximation of the objectives of the portfolio, but has significant design differences that can create poor performance comparisons over short periods of time. For example, the Index does not include commodity trading advisor strategies, which are present in the portfolio and had a particularly poor year. In addition, the index has more equity exposure than the Absolute Return portfolio. This exposure has had a significant impact as equities have experienced very strong performance in the last several years.

Comptroller Franchot then asked about Tiger Iron. Mr. Palmer said that there has been no change since the last update in May, and no performance numbers because they just started investing. Approximately \$20 million had been drawn and invested. Comptroller Franchot then asked how many other strategies similar to Tiger Iron were in the portfolio. Mr. Palmer responded that Tiger Iron was the only fund of funds manager investing solely in venture capital.

Comptroller Franchot requested an update on the investments made through Tiger Iron. Treasurer Kopp commented that the CIO Report is comprehensive and informative. She also asked if there is something that can be done about the hedge fund benchmark misfit. Mr. Palmer replied that he will speak with Meketa regarding possible alternatives that may better reflect the objectives of the Absolute Return program.

Mr. Palmer closed by noting that while not large, the System's alpha generation for the fiscal year was an accomplishment. As noted in past meetings, the System's managers have styles that do not perform in every market environment. The end of fiscal 2016 and the beginning of fiscal 2017 was one such period. He pointed out that the System had lagged its benchmark by more than 150 bps for the trailing year as of February, and strong performance, including performance generated through tactical asset allocation by staff, had reversed that trend to end the fiscal year in positive territory.

**Item 5: Pavilion Alternatives Group Report**

Mr. Ferguson introduced Brad Young and Jim Treanor, of Pavilion Alternatives Group, who presented an update on the private equity program.

Mr. Young spoke about the merger between Altius and Pavilion. The combined firm now has 290 employees and 8 offices around the world. He stated that they reviewed 952 funds this year. Mr. Young discussed the current prospects for Private Equity investments. He also reviewed the performance of the Private Equity Portfolio, citing the high proportion of first and second quartile funds at 72% of dollars committed and the very low proportion of fourth quartile funds at only 12%. He noted that returns have been consistent across geographies and across sectors. He presented an alternative measure of performance, the Public Market Equivalent (PME). By this measure, which compares what would have happened if the capital drawn by private equity managers instead had been invested in passive public market stocks. The System has earned nearly 300 bps (3%) greater than the PME over a ten-year time frame. Comptroller Franchot asked if they did a review of Tiger Iron. Mr. Young indicated that Pavilion did a structural review, but not a full review. He noted that Pavilion was aware of the investment and had known the principals for more than twenty years.

Comptroller Franchot asked to see the reports provided to staff and requested that Pavilion do a full analysis of Tiger Iron. Mr. Young said he will coordinate with staff.

Ms. Herman asked if Pavilion and staff attend annual meetings. Mr. Young confirmed that Pavilion attends most annual meetings, and sometimes staff will attend also. Ms. Herman asked why both groups needed to go. Mr. Ferguson replied that staff is ultimately responsible for the investments and diligence on the System's private equity investments, and that relying exclusively on Pavilion reports of the meeting is not as effective as attending in person. However, Mr. Ferguson indicated that staff generally does not attend annual meetings if the system is not planning to invest in a manager's future funds, or if it doesn't make sense geographically.

**Item 6: Summer Study Update from CIO**

Mr. Palmer reviewed the presentation and explained that some of this material will go to the legislature next month. The objective is to remove the Investment Division from the State budget process to make it the responsibility of the Board to approve the Investment Division budget, to be paid from plan assets. The budget would no longer be an administrative expense charged to the participating employers. He reviewed the direction for the study from the legislature. Mr. Palmer pointed out that the System is one of four large state pension plans that has no internal management. He also detailed that fees will grow to over \$570 million under the current structure. In addition to fee savings, the System could potentially improve returns through internal management.

Mr. Jennings asked if staff have considered third party administrators. Mr. Palmer indicated that staff had discussed that option. Mr. Hughes asked what needed to be done to move this forward. Mr. Palmer said he would ask the Board to request legislation be sponsored by the Joint Committee on Pensions at the next Board meeting, and indicated that the Board might have to consider changes to committee charters before the legislation became effective. Mr. Hughes asked if this would require a compensation committee. Mr. Palmer replied that either a separate committee would likely need to be formed, or an existing committee would need to take on the responsibility. Mr. Brotman asked what the expenses look like for the near future. Mr. Palmer referred to the exhibit on page 19 which showed that staffing expenses would increase by \$3 million to hire 9 new staff members and adjust existing compensation levels, and approximately \$4 million for additional systems and products.

Mr. Jennings asked if he could get data on the correlation between performance and funds that are internally managed. He stated that he would send an email with details of his request.

Mr. Hughes noted that if the legislation were to become effective, there would need to be system and disclosure in place to protect the integrity of salary setting and other personnel matters.

Comptroller Franchot wanted to know whether there had been any consideration by the System's internal management consultant, Cutter Associates, on outsourcing the entire Investment Division. Mr. Palmer responded that outsourced CIO models are uncommon for investors larger than \$5 billion in assets.

Treasurer Kopp stated she had concerns about going to the Legislature with plans to add 73 people. She suggested that the incremental nature of the vision, with appropriate evaluation points along the way be made clear to the legislature. Mr. Palmer agreed and noted that many plans with internal management utilize fewer personnel, and that the projections should be considered in the context of a business case where it is important to show all the potential costs.

#### **Item 7: Leverage Analysis**

Mr. Palmer discussed the Use of Plan Level Leverage presentation. He discussed the reasons to use leverage, the portfolio options to add leverage, how to use leverage, and implementation strategies. He indicated that inflation linked bonds and hedge funds are good candidates for leverage because of their low correlation to other asset classes and moderate returns. However, in the current environment, the negative real yields of global inflation linked bonds reduce their attractiveness because the expected levered return is low even though the diversification benefits are high. Mr. Brotman asked if Mr. Palmer was recommending that they implement plan level leverage. Mr. Palmer replied not at this time, but that the discussion should continue. His view is that the use of leverage may permit the System to improve investment outcomes, but that it requires further discussion and communication with stakeholders. In the case of a levered global inflation linked portfolio, Mr. Palmer noted that with negative real yields and the blended cost of leverage positive, the expected return of global inflation linked bonds is very low, unless real yields become more negative or global inflation is significantly higher than forecast. Ms. Herman commented that Montgomery County had employed a successful levered global inflation-linked bond mandate in low/negative yield environments.

#### **Item 8: Investment Reports**

The Committee received the following investment reports:

- State Street Performance Reports
- Terra Maria Performance Report
- Private Markets Performance Reports
- Securities Lending Report
- TUCS Report
- Division's FY18 Travel Plan - Update

- Quarterly ORP Performance Report
  - OPEB-PHBT Update
  - New Hire Manager Report
- On the Directors Desk:
- Broker Commission Reports

On a motion made by Mr. Brotman and seconded by Ms. Lochte, the Investment Committee voted without objection to meet in closed session at 12:43 p.m. for the purposes of:

(a) reviewing the closed session special Investment Committee minutes, pursuant to General Provisions Art., Section 3-103(a)(1)(i), the exercise of an administrative function; and

(b) conducting an evaluation of the CIO's performance pursuant to General Provisions Art., Section 3-305(b)(1), consideration of a personnel matter.

**CLOSED SESSION**

Committee Members  
Attending:

Michael K. Barry  
David Brinkley  
Eric Brotman  
Peter Franchot  
James Harkins (1)  
Linda A. Herman, Vice-Chair  
Sheila Hill  
F. Patrick Hughes, Chairman

Lisa James-Henson  
Larry E. Jennings, Jr.  
Charles W. Johnson  
Stephen Kitsoulis  
Nancy K. Kopp  
Theresa Lochte  
Richard Norman  
Douglas Prouty

Committee Members  
Not Attending:

David Hamilton

Also Attending:

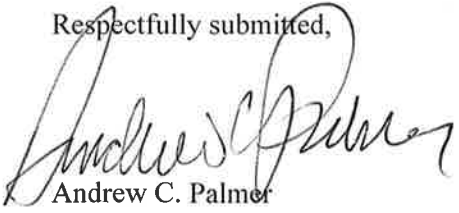
Victor Adekoya  
Frank E. Benham (Meketa)  
Colleen Bower  
Susanne Brogan  
Robert Burd, Deputy CIO  
Elizabeth Burton  
Antionette Butcher  
Rachel Cohen, OAG  
Eric Farls  
David Ferguson  
Anne Gawthrop  
Dimitri Grechenko  
Alex Harisiadis, OAG  
Justin Hayes  
Dana Johns  
Faina Kashtelyan

Gregory Kasten  
Larry Katsafanas  
Dean Kenderdine  
John Kenney  
Michael McCord  
Mary Mustard (Meketa)  
Stephen Muturi  
Andrew Palmer, CIO  
Stephen Reilly  
David Rongione, Chief Internal Auditor, Internal Auditing Div.  
Dan Schick  
Jody Shaw, OAG  
Frederick "Beau" Smith  
Toni Voglino

Adjournment

There being no further business before the Investment Committee, on a motion made and seconded, the meeting adjourned.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Andrew C. Palmer". The signature is written in a cursive style with a large initial "A".

Andrew C. Palmer  
Chief Investment Officer